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Years before the ENRON debacle, the Supreme Court heard a pair of cases involving dishonest financial accounting, *Frank Lyon Co. v. U.S.*¹ and *Cottage Savings Ass'n. v. Commissioner*.² Both cases raised fundamental tax law issues concerning who really owns property and when losses are deductible. The cases also shared a peculiar genesis. In both cases, federal bank regulators had encouraged deceptive financial accounting in order to circumvent statutes intended to protect bank depositors, and the deceptive accounting became the basis for taxpayer claims.

The Supreme Court, however, did not comment in either opinion on the deceptive character of the financial accounting that gave rise to tax litigation. In one sense, this omission is understandable. The Internal Revenue Service had no standing to challenge the decisions by the bank regulators to countenance deceptive accounting. Thus, the propriety of the accounting was not a legal issue in either case. Nevertheless, it is astonishing that the Court did not mention, even in passing, that the tax issues arose only

¹ 435 U.S. 561 (1978).

² 499 U.S. 554 (1991).

because bank regulators, charged with promoting fair and accurate accounting disclosure, violated their public trust.

The first case, *Frank Lyon*, involved a transaction between the taxpayer and Worthen Bank, located in Little Rock, Arkansas. Worthen had spent \$10 million on a new headquarters building. The bank was subject to regulation by the Federal Reserve System and needed Federal Reserve approval of its spending for the new building. The Federal Reserve ruled that the \$10 million cost exceeded statutory limits on the amount that a bank could spend on its premises and therefore refused to permit Worthen to continue to own the building.

The Federal Reserve did, however, approve an arrangement, different in form but not in substance, under which Worthen could use the building without actually owning it. First, Worthen sold the building to Frank Lyon Co. for \$7,640,000, which was \$2,360,000 less than the building's actual cost. Frank Lyon financed the \$7,640,000 price with a \$500,000 cash payment plus a 25-year mortgage loan from New York Life Insurance Co. for the \$7,140,000 balance.

Second, Frank Lyon leased the building back to Worthen for 25 years. The lease was a full payout lease that would fund repayment of the mortgage; each year for 25 years, the rent owed by Worthen to Frank Lyon equaled the mortgage payment owed by Frank Lyon to New York Life. The lease was also a net lease; the lessee, Worthen, was responsible for all expenses of the building, including utilities, maintenance, insurance, property taxes, and so on.

Third, Frank Lyon granted Worthen an option to repurchase the building during the 11th through 25th years of the lease. To exercise the repurchase option, Worthen had

to pay Frank Lyon an amount equal to the \$500,000 cash down payment plus 6% interest on that down payment compounded to the date of the option's exercise and, in addition, had to assume the unpaid balance of Frank Lyon's mortgage obligation.

Worthen was virtually certain to exercise the option because it was "in the money," that is, the exercise price was almost certain to be substantially less than the building's market value. For example, at the end of the 25th year, when the mortgage was fully paid off, the exercise price was \$500,000 plus interest at six percent compounded for 25 years, or \$2,150,000 total. The building, which cost \$10 million, would have to lose nearly eighty percent of its value before exercise of the repurchase option would no longer make sense.

That Worthen expected to exercise the option is also indicated by the sales price to Frank Lyon, which was only \$7,640,000, an amount \$2,360,000 less than the building's \$10 million cost. Worthen was presumably willing to sell the building below cost only because it planned to recoup the \$2,360,000 difference by exercising the option to repurchase the building in the future.³

At this point in the narrative, it should be apparent that the economic relationships among Worthen, the mortgagee (N.Y. Life), and Frank Lyon were virtually identical to the relationships between an owner, a first mortgagee, and a second mortgagee, respectively. Worthen's investment in the leasehold and repurchase option was no different from that of an owner who finances the \$10 million cost of a building with a

³ As an alternative to exercising the repurchase option, Worthen could renew the lease for up to five additional eight-year terms. The rents specified for the eight renewal periods would also have provided Frank Lyon with the equivalent of \$500,000 compounded at six percent.

\$2,360,000 cash down payment, a \$7,140,000 first mortgage, and a \$500,000 second mortgage. Worthen could obtain full ownership of the building free and clear of the claims of others by repaying the amounts, plus interest, advanced by the other two parties to the transaction. Whether Worthen formally owned the building, as it originally desired, or was a lessee with a repurchase option, as the Federal Reserve permitted, had no real impact whatsoever on the amount that Worthen actually spent on the building.

The reader may therefore wonder what the Federal Reserve was thinking when it prevented Worthen from owning the building, on the grounds that ownership would violate statutory limits on what a bank may spend on its premises, but approved equivalent spending through a lease with an option to repurchase.⁴ It seems inconceivable that the Federal Reserve did not understand the financial equivalence.

The Federal Reserve apparently wanted to permit Worthen to evade the statutory limits on the amount a bank can spend on its own premises. In order to achieve this objective, however, the banking regulator condoned deceptive accounting. In calculating how much the bank spent on its premises, the Federal Reserve counted only the cost of

⁴ Two decades later, in a virtually identical transaction involving a building, the Comptroller of the Currency decided that it was really the lessee with the option to repurchase who had invested in real property. In this transaction, a nonbanking business was the long-term lessee of real estate and held an option to repurchase at a bargain price, while the lessor (and nominal owner) was a bank. The issue was whether the bank had invested in real estate in violation of federal statutory limits. The Comptroller held that the bank did not really own the real estate but had simply provided financing. Therefore, the arrangement did not violate statutory limits on how much a bank could spend on real estate. *OCC Interpretive Letter No. 806* (October 17, 1997).

real property to which the bank held legal title and excluded the cost of the leasehold interest and repurchase option.⁵

How did this accounting subterfuge produce litigation over taxes? Since the Federal Reserve considered Frank Lyon rather than Worthen to be the building's owner, Frank Lyon presumed that it could claim depreciation deductions for the building on its tax return. The Internal Revenue Service (IRS) challenged this claim on the ground that Frank Lyon was not the real owner for tax purposes.

To the IRS, it must have seemed an easy case, with the legal precedents clearly supporting its position. In similar circumstances in 1939, the Supreme Court had held that the lessee with an option to repurchase at a bargain price was the owner for tax purposes.⁶ The federal courts had applied this rule consistently for decades to distinguish between a financing party who holds formal legal title and the real owner for tax purposes.⁷ While the Federal Reserve might treat Worthen as not owning the building for purposes of enforcing federal limits on a bank's investment in its premises, for purposes of the tax law, the building's real owner was Worthen.

True, Frank Lyon initially prevailed before a friendly judge in the taxpayer's local Federal District Court in Little Rock, Arkansas.⁸ The trial court, however, based its

⁵ Generally Accepted Accounting Principles require a lessee to treat a so-called "capital lease" as constituting ownership of the leased property. A lease is considered a capital lease if the lessee has an option, as Worthen did, to purchase the leased property at a bargain price. *See* DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS, 843-45 (2001)

⁶ *Helvering v. Lazarus & Co.*, 308 U.S. 252 (1939).

⁷ *See* *Estate of Starr v. Commissioner*, 274 F.2d 294 (9th Cir. 1959).

⁸ 36 AFTR2d 75-5254 (E.D. Ark. 1975).

decision for the taxpayer on an a patently false finding: that the exercise price provided in the option to repurchase reflected, not a bargain price, but the parties' best estimate of the full fair market value of the building at the future time when the option would be exercised.⁹ On appeal, the Eighth Circuit predictably reversed.¹⁰

Tax lawyers were therefore surprised when the Supreme Court decided that Frank Lyon was the real owner for tax purposes and could take depreciation deductions for the building.¹¹ What might explain this unprecedented result? The Court emphasized Federal Reserve approval of the transaction that designated Frank Lyon as the building's owner.¹² You might think of the Court's decision as exemplifying the principle of cross-

⁹ 435 U.S. 561, 572, n. 6.

¹⁰ 536 F.2d 736 (8th Cir. 1976).

¹¹ See Bernard Wolfman, *The Supreme Court in The Lyon's Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075 1087-88 (1981). The taxpayer in *Frank Lyon* made an inspired choice of counsel to prosecute the appeal of the unfavorable outcome in the Circuit Court. The taxpayer selected a former "Tenth Justice", Erwin Griswold, who had served as Solicitor General from 1967 to 1973 and, as a consequence of his former position, may have unduly influenced the outcome.

¹² The Court offered two other justifications for concluding that Frank Lyon was the owner for tax purposes and for distinguishing its earlier precedent, *Helvering v. Lazarus*, 308 U.S. 252 (1939), in which it held that a lessor in similar circumstances was not the real owner. First, the Lyon Court ruled that Frank Lyon had incurred significant risks because it was liable for the entire \$7,140,000 mortgage in the event that Worthen defaulted on the rent. However, Frank Lyon's potential liability was simply a financing risk, indistinguishable from the financing risk incurred by the lessor in *Lazarus*. Second, the Court stated that the case involved a three-party transaction, in which a third party mortgagee provided financing for the sale of the building from the Worthen to Frank Lyon, whereas the *Lazarus* transaction, which was seller-financed, had only two parties, the seller and the buyer. However, the court never explained why third-party financing should make a difference. If anything, the existence of a third party meant that the lessor in *Frank Lyon* incurred even less risk than the lessor in *Lazarus* and therefore should have been even less likely to be considered the tax owner of the building. Third-party financing is logically relevant only if there is a chance that the price paid for depreciable

town estoppel: a federal agency in one part of the town of Washington, D.C., namely the IRS, is estopped from challenging a transaction endorsed by a different federal agency in another part of town, the Federal Reserve.¹³

The Court may also have been reluctant to create an unfair windfall for Worthen at Frank Lyon's expense. Depreciation deductions are a valuable tax benefit. If Frank Lyon was not the real owner for tax purposes and could not deduct the depreciation, then Worthen was the real owner who could. Yet the terms of the repurchase option – providing a six percent cash return on the \$500,000 in financing provided by Frank Lyon – were negotiated with the expectation that Frank Lyon would obtain tax benefits by depreciating the building.¹⁴ A Supreme Court decision for the IRS therefore would therefore have upset the bargain reached by the parties with the Federal Reserve's approval.¹⁵

property is being inflated, a circumstance that did not arise in either *Lazarus* or *Frank Lyon*.

¹³ This estoppel principle supposedly protects citizens from being whipsawed between two different federal bureaucracies with different points of view.

¹⁴ Thus, the return on the \$500,000 that Frank Lyon contributed to the transaction was to consist of two components: cash payments from Worthen equal to 6 percent interest plus depreciation deductions for the building. If Frank Lyon had thought that the depreciation was Worthen's, then presumably the repurchase option would have provided for larger cash payments from Worthen in order to provide an adequate return on the \$500,000 in cash that Frank Lyon advanced.

¹⁵ The Court apparently never considered the possibility that Frank Lyon did not deserve sympathy or protection because Frank Lyon could and should have taken steps to protect its position. Frank Lyon could, for example, have consulted tax counsel before assuming that it would be able to depreciate the building rather than simply relying on the fact that the Federal Reserve had approved the deal. Counsel would have advised that Frank Lyon's claim of depreciation deductions for the building would almost certainly be challenged. Frank Lyon then could have insisted that the repurchase option provide for Worthen to indemnify Frank Lyon, by making an additional cash payment, in the event

The accounting deception was even more egregious in the second Supreme Court case, *Cottage Savings*. During the 1970s, the assets of Savings and Loan Associations (S&Ls) consisted largely of long-term, fixed interest rate home mortgages. These assets plummeted in value when market interest rates rose dramatically during this period. As a result, the S&L industry was in crisis, with thousands of institutions on the verge of bankruptcy, threatening the savings of millions of depositors.

The Federal Home Loan Bank Board (FHLBB) was the government agency responsible for supervising S&Ls. On the advice of the FHLBB, Cottage Savings swapped its existing home mortgages for different mortgages with the same risk and expected return characteristics. The FHLBB encouraged thousands of other S&Ls in the same position as Cottage Savings to engage in similar mortgage swaps in order to realize the losses and claim a deduction for tax purposes. The FHLBB also ruled that losses from mortgage swaps – which it believed would be deductible for federal tax purposes – would *not* have to be reported for purposes of financial accounting because they effected no real change in the economic position of the S&Ls.

The FHLBB's objective in promoting the mortgage swaps was to enable S&Ls to deduct tax losses without recording the losses on their balance sheets. The FHLBB understood that financial accounting disclosure of the losses would have revealed that many S&Ls were actually insolvent, and federal statutes would then have required the FHLBB to shut down the insolvent S&Ls. Thus, the FHLBB, like the Federal Reserve in *Frank Lyon*, was circumventing statutory rules intended to protect the public.

that Frank Lyon was denied depreciation deductions for the building and Worthen consequently received the depreciation's tax benefits.

The FHLBB's nondisclosure rule, moreover, was contrary to *Generally Accepted Accounting Principles* (GAAP), which require a loss on property to be reported *no later than* the time when the loss is realized through a sale or exchange. When unrealized losses are unusually large, as in the case of S&Ls in the late 1970s, these principles advise (but do not require) that the losses be disclosed in order to convey an accurate picture of the subject's financial position, even though the losses have not yet been realized through a sale or exchange.

Given the public's stake in knowing if a bank faces insolvency, the large losses of the S&Ls, *whether realized or not*, should have been disclosed for financial accounting purposes. The FHLBB's failure to require reporting of such unrealized losses was bad enough. To authorize the nondisclosure of those losses, even when realized through a mortgage swap, was blatantly dishonest and helped conceal the festering savings and loan crisis.

If the S&Ls had reported the losses for both financial reporting and tax purposes, the IRS would probably not have complained. It was the inconsistent treatment that seems to have caused the IRS to challenge the deductions for losses realized when existing mortgages were swapped for different mortgages with the same risk and expected return.

This time the legal precedents did not favor the IRS. The tax law generally treats losses as deductible when realized through a sale or exchange even if the taxpayer acquires other property with the same economic characteristics.¹⁶ A deduction is

generally disallowed only if the taxpayer replaces the property sold or exchanged with virtually *identical* property.¹⁷ It was therefore unsurprising that the Supreme Court ruled for the taxpayer in *Cottage Savings* and held that the losses were deductible for tax purposes even if not disclosed for purposes of financial accounting. The Court, however, once again failed to mention the deceptive character of the financial accounting that gave rise to the tax litigation.

The S&L crisis had more than enough villains: bank executives who made imprudent loans; federal regulators who encouraged deceptive accounting; and elected officials who refused to act until a federal bailout of the S&L sector, costing hundreds of billions of dollars, became necessary. Compared to these miscreants, the Supreme Court in deciding *Cottage Savings* was just a bystander. Yet even a bystander has a civic (if not a legal) duty to report illegal behavior when he or she observes it. So perhaps the Court should have mentioned the FHLBB's dishonesty and dereliction in its opinion in *Cottage Savings*, even if the mention would have been mere dictum, especially since the purpose of the deception was to evade statutory requirements intended to protect the public.

We can even imagine what might have happened if the Court had criticized the Federal Reserve for condoning deceptive accounting in its earlier opinion in *Frank Lyon*. The FHLBB might have been less eager a few years later to encourage deceptive accounting that covered up the S&L crisis. Even ENRON's managers and accountants, two decades later, might not have made such egregiously false financial claims.

¹⁶ See *Smith v. Commissioner*, 78 T.C. 350 (1982), affirmed, 1820 F.2d 1220 (4th Cir. 1988). The exception in § 1031, providing for nonrecognition of losses on exchanges of properties of like kind, does not apply to mortgages.

¹⁷ See I.R.C. § 1091(a); *Horne v. Commissioner*, 5 T.C. 250 (1945); *McWilliams v. Commissioner*, 331 U.S. 694 (1947); *Smith*, *supra* note 15.